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March 22, 1995

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, DC 20554

RE: Ex Parte Presentation in Price Cap Performance Review CC Docket No. 94-1

Dear Mr. Caton:

This notice of an oral ex parte presentation in the above-referenced proceeding and the attached materials are provided for inclusion in the public record pursuant to the Commission's Ex Parte rules at 47 C.F.R. §1.1200 et seq. Thomas F. Railsback, Esq. who represents BellSouth met with Commissioner Rachelle Chong and Richard Welch, Legal Advisor to Commissioner Chong, to discuss BellSouth's position and to rebut positions advanced by opponents in ex parte presentations in this proceeding.

The discussions at the meeting were consistent with BellSouth's position already on file in this proceeding. The attached materials were passed out during the meetings as an aid to the discussion. Also, attached is a copy of a facsimile which I sent to Commissioner Chong after our meeting this morning.

If you have any questions regarding this matter, please do not hesitate to call the undersigned.

With best wishes,

Tom Railsback

Thomas F. Railsback, Esq.

sr
Attachments

cc: Commissioner Rachelle Chong (w/o attachments)
Richard Welch (w/o attachments)

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List A B C D E

A Factual Assessment of the LECs' Price Cap Plan

- *LEC Price Cap Plan Is Lowering Access Charges.* Since LEC price cap plan was implemented in January 1991, interstate access charges have declined by nearly **13 percent**, as compared to a **10 percent** increase in the consumer price index and a **12 percent** gain in the Bureau of Labor Statistics' price index for interstate MTS service. (Fig. 1)

- *LEC Price Caps Have Spurred Investment In The Infrastructure.* Since price caps were implemented, Bell operating companies have invested **52 percent** of their cash flow from local telephone operations in network facilities versus **48 percent** during the 1988-90 time frame. By contrast, the share of cash flow from long distance services that AT&T, MCI and Sprint reinvested in their respective networks declined from 57 percent during 1988-90, to 48 percent during 1991-93. (Fig. 2) Current investment rates imply that each dollar in cash shifted from the LECs (52% of cash invested) to IXCs (48%) will reduce investment by 4 cents.

- *LECs Have Not Profiteered From Price Caps.* Since 1991, total cumulative returns (i.e., dividend yield plus percentage change in price per share) to regional Bell company and GTE shareholders have remained <u>below</u> the S&P 500. (Fig. 1) Lackluster performance of these stocks indicates that true profitability of regulated local telephone services, including access services, are certainly not excessive. Economic returns on access services also tend to be well below accounting returns because regulated depreciation rates are too low and, thus, overstate reported earnings. In 1993, BellSouth's reported rate of return on interstate access services would have declined from **13.7% to 10.2%** if the company had been permitted to use the same depreciation rates that currently apply to AT&T's network operations. (Fig. 3)

- *LEC Shareholders Are Being Penalized For Investing In Upgraded Local Networks.* Since 1988, cumulative returns to RHC shareholders have varied <u>inversely</u> with the portion of total cash flow from local telephone operations that each of the companies reinvested in their local networks. That the stock market has rewarded individual RHCs for investing <u>less</u> in new network facilities is further evidence that true rates of return on local telephone services are, if anything, too low. Given that local telephone operations of the RHCs necessarily compete with other investment opportunities, any FCC action that reduces economic returns on access services will very likely diminish investment and slow the deployment of new technologies. (Fig. 4)

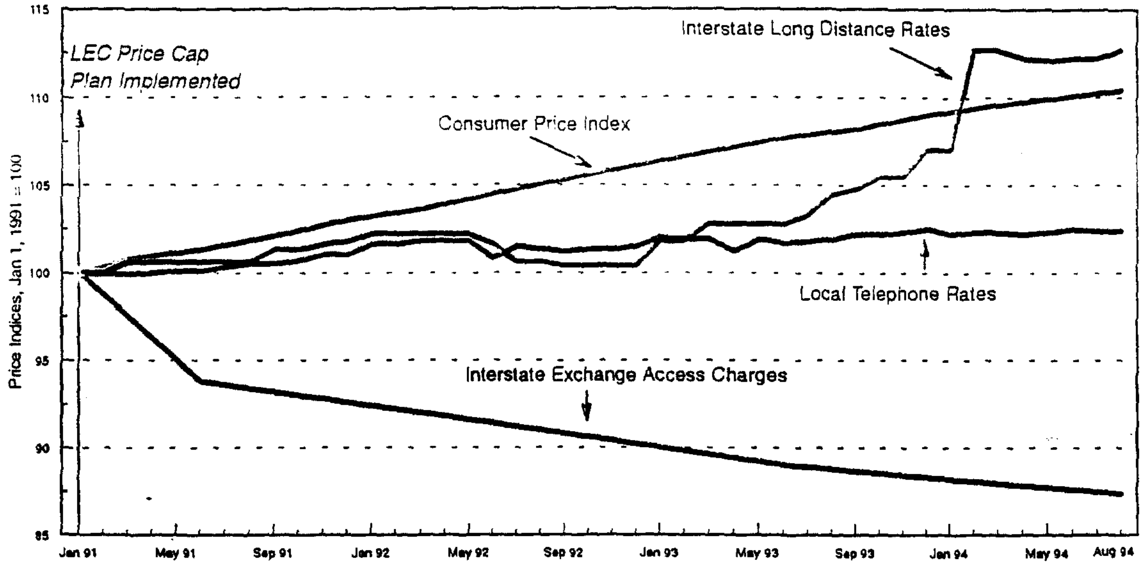
- **LEC Access Rate Cuts Are Being Flowed Through To IXC Shareholders.** Since 1991, MCI, Sprint and other long distance carriers have followed AT&T's lead in raising rates every six months or so, despite continuing reductions in interstate access charges. (Fig. 5) Subsequent improvements in IXC operating profit margins have resulted in even sharper increases in cumulative returns to IXC shareholders. (Table 1 and Fig. 1)

Modifying the LECs price cap plan in ways that further reduce earnings, therefore, will only further enrich IXC shareholders, while slowing investment in new network technology. At a time when the economy is becoming more and more information intensive and demanding an ever larger array of network services, consumers would be well served by eliminating the last vestiges of rate-of-return regulation (i.e., earnings sharing) and moving to a pure system of price regulation.

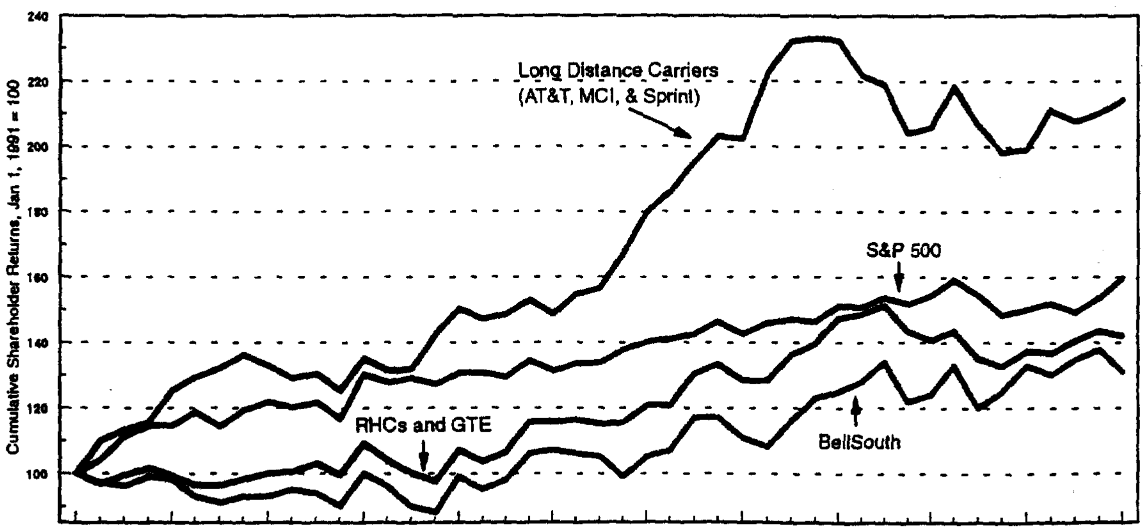
Figure 1

Recent Trends In Prices And Shareholder Returns In Local And Long Distance Telecommunications Markets

Despite reductions in exchange access charges that have occurred since the LECs' price cap plan was implemented in January 1991, the interexchange carriers (IXCs) have raised interstate long distance rates sharply over the past 2 years. . .



. . . shifting billions of dollars from local and long distance customers to IXC shareholders.

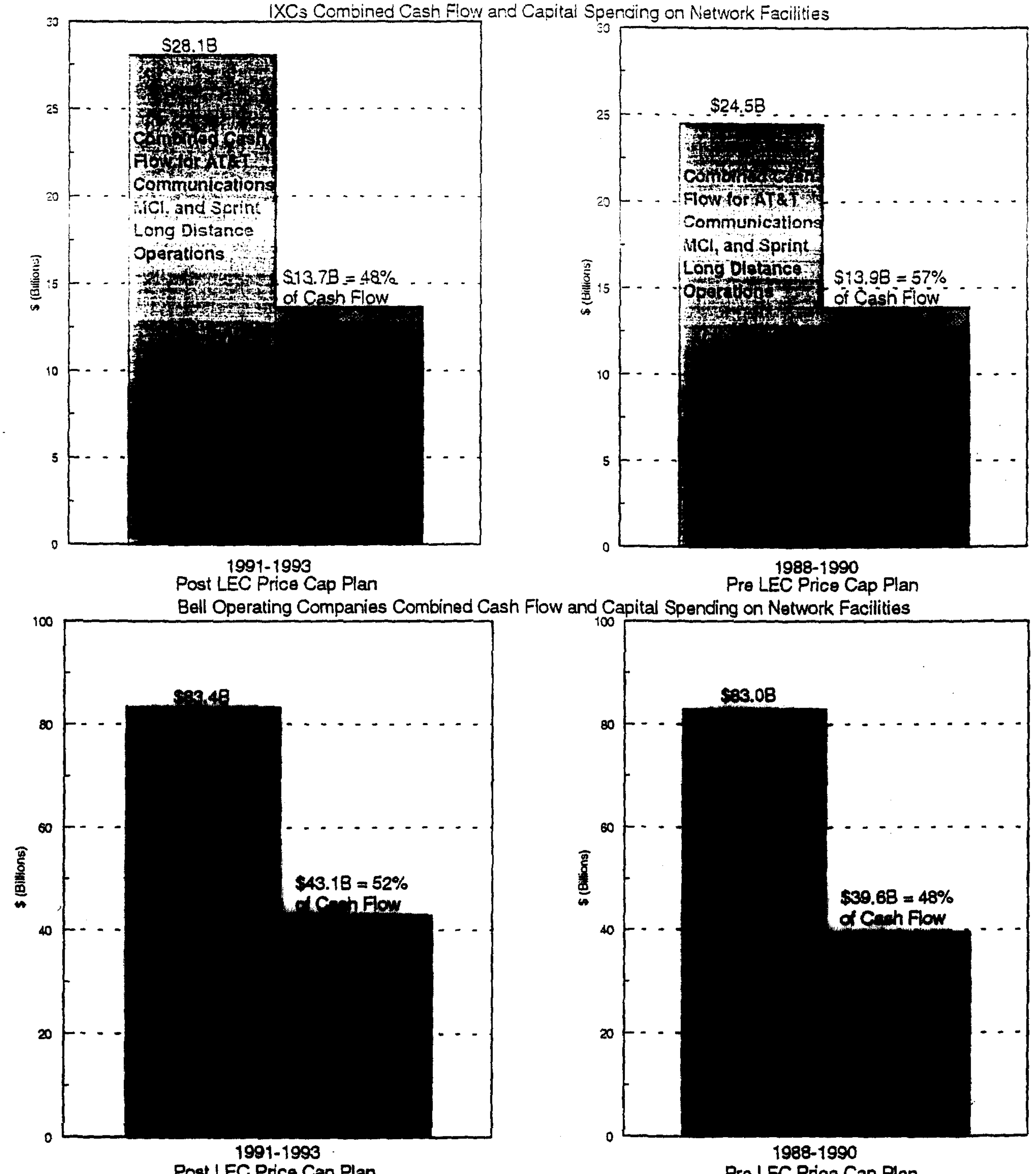


Note: Cumulative shareholder returns are based on market weighted monthly averages of total shareholder returns for individual companies.

Sources: Bureau of Labor Statistics, FCC, Compustat

Figure 2

Percentage of Cash Flow that the Interexchange Carriers and Bell Operating Companies Have Invested in Their Respective Telecommunications Networks Before and After the Implementation of Price Caps

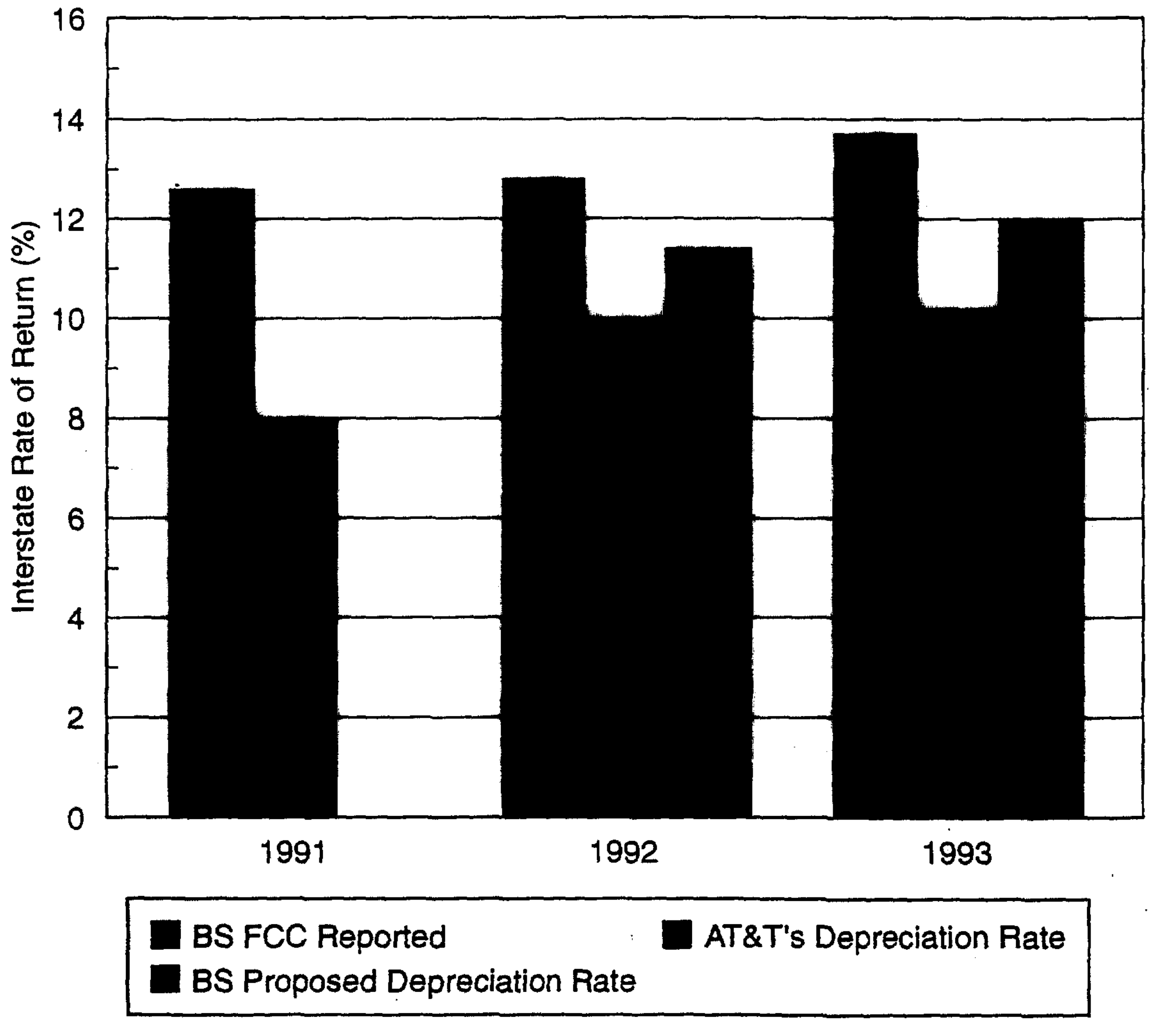


Note: Cash flow is earnings before interest, taxes, and drepreciation and amortization.
Sources: Compustat and FCC Form M

Figure 3

BellSouth's 1993 Interstate Rate of Return Would be Nearly Four Percentage Points Lower if it Depreciated its Plant and Equipment at the Same Rate AT&T Depreciates its Plant and Equipment

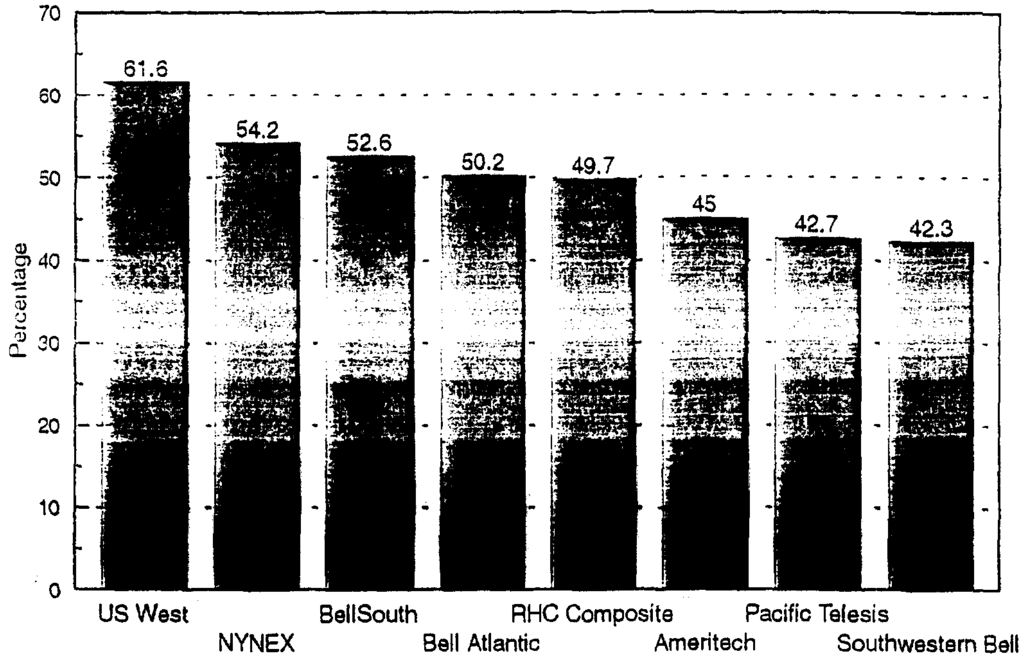
	BellSouth Reported Earnings	Earnings with AT&T Depreciation Rate	BellSouth Proposed Depreciation Rate
1991	12.6%	8.0%	N/A
1992	12.8%	9.9%	11.4%
1993	13.7%	10.2%	12.0%



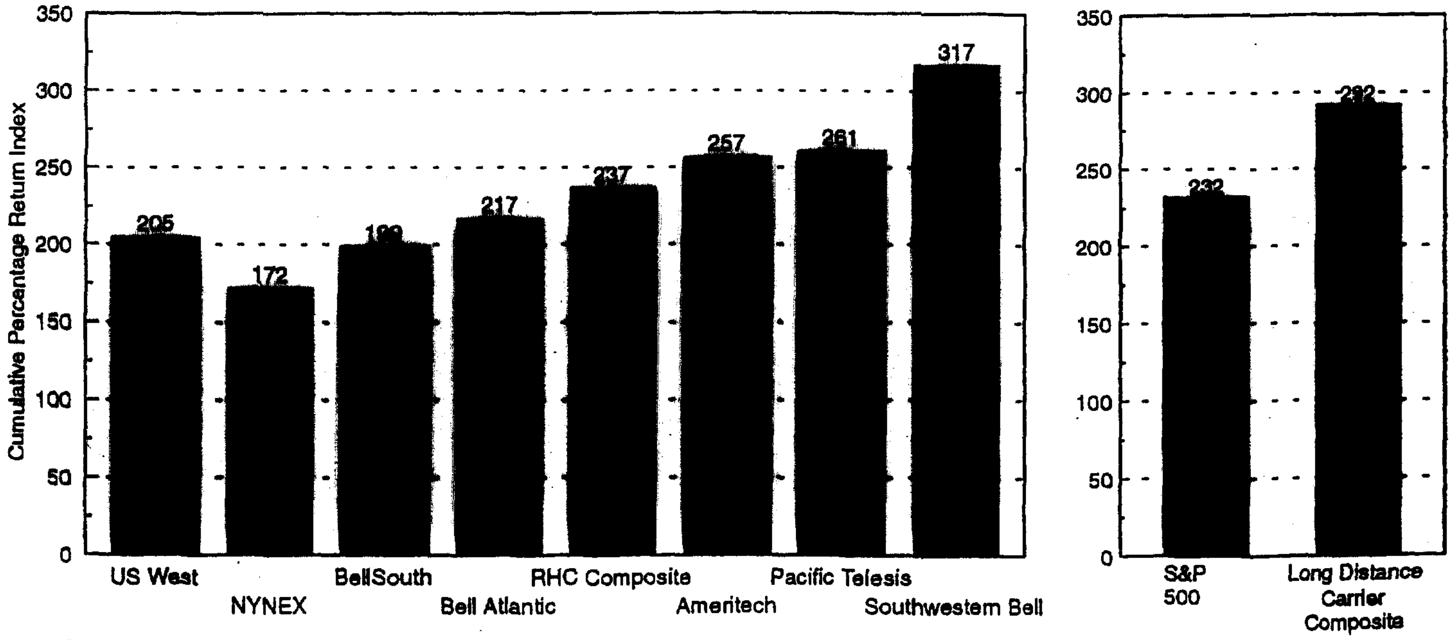
Note: BellSouth's depreciation rate not applicable in 1991

Figure 4

Bell Operating Company's Capital Spending as Percent of Cash Flow 1988-1993



RHC Cumulative Shareholder Return 1988-Present

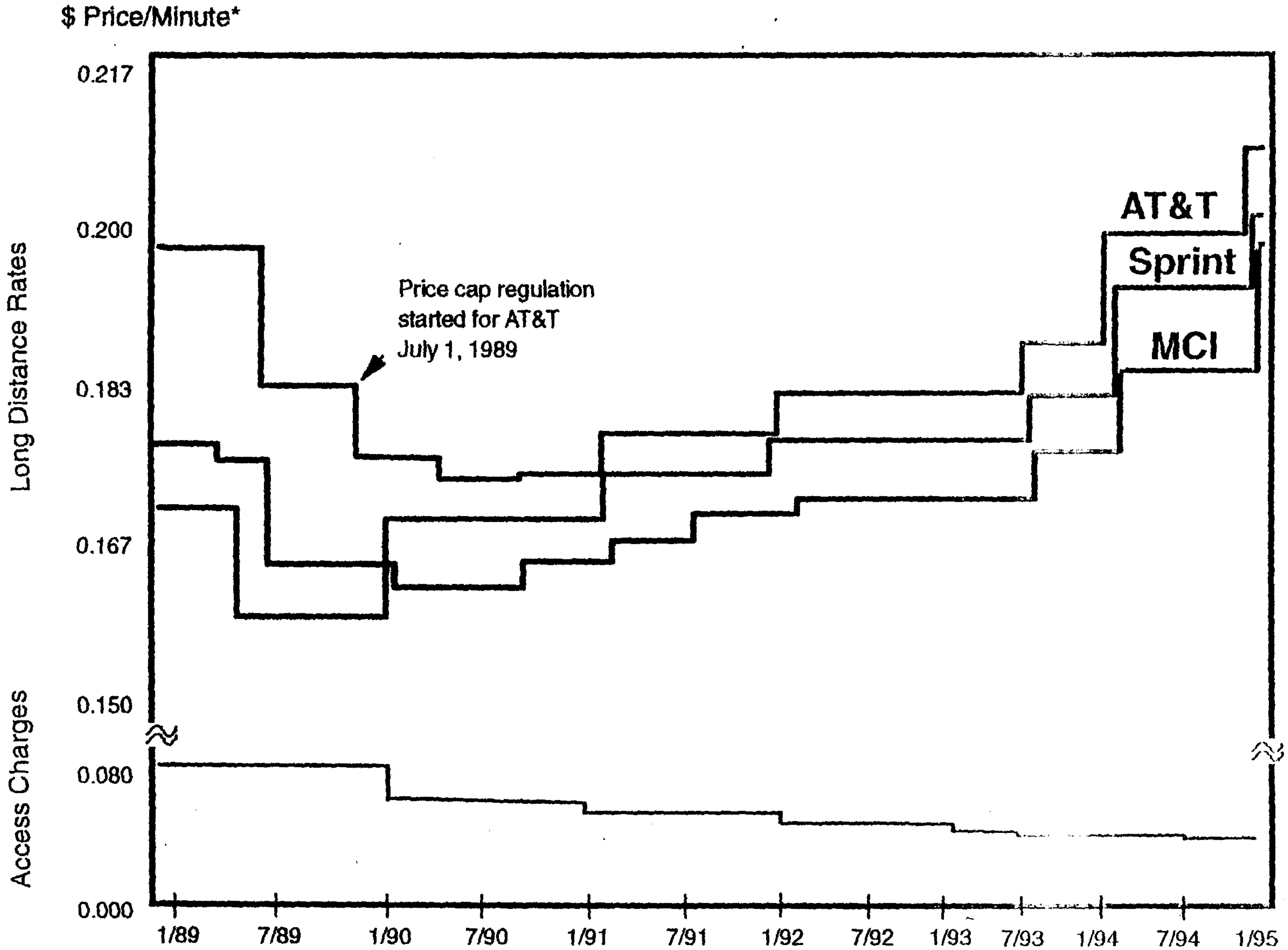


Source: One Source and Compustat

Note: Cash flow on earnings before interest, taxes and depreciation, and amortization. Cumulative shareholder return includes dividend yield and price appreciation of RHC stocks since January 1, 1988.

Figure 5

Trends in Long Distance Rates and Exchange Access Charges



*Long distance rates based on the average price per minute for basic service.

Table 1

AT&T's Telecommunications Services

Dollars in Millions	1991	1992	1993	% Change 1991-93
Total Revenues	$38,805	$39,580	$39,863	+2.73%
Access & Other Interconnection Costs	$18,395	$18,132	$17,709	-3.73%
Gross Profit Margin	34.9%	36.2%	38.0%	+8.88%

The View From Wall Street: Competition in the Long Distance Telephone Market

AT&T and its rivals are pushing some prices up after almost 10 years of steady discounting. This gives AT&T more room to grow profits, and it creates an umbrella over MCI and Sprint, allowing them to raise prices, too. *(Kenneth Leon, Bear Stearns, 10/20/92)*

AT&T, MCI, and Sprint all have high-quality earnings because they operate in a stable, oligopolistic industry. . .without serious price competition. [T]he only real threat [is] posed by the Regional phone companies which are unlikely to gain regulatory freedom to enter this business for at least 3-5 years. *(Philip A. Managieri, Cowen, 8/23/93)*

Margins improved for all four [long distance] carriers, reflecting an impact from price increases and steady declines in access costs. *(Daniel P. Reingold and Richard C.Toole, Merrill Lynch, 2/10/94)*

The combination of a cozy oligopoly that wishes to avoid price wars and falling operating expenses primarily due to [exchange] access cost reductions is an unbeatable environment in which to do business. *(Timothy N. Weller and Nick Frelinghuysen, Donaldson, Lufkin & Jenrette, 6/1/94)*

The long distance industry is one of today's premier growth industries. Where else can you find: (1) double-digit unit volume growth, (2) declining unit costs, on a nominal as well as real basis, (3) a $10 billion barrier to entry, (4) a benign, stable oligopoly where the price leader [AT&T] is looking to generate cash to fund other ventures, and (5) a prohibition on competition. . . It is rare to see a full-fledged price war in an oligopolistic market, witness soft drinks. The same holds true in the long distance market. *(G.W. Woodlief and E. Strumingher, Dean Witter, 10/28/94)*

Many investors still seem to believe that there has been some sort of "price war" among the major interexchange carriers. The fact is that although interstate telephone rates have come down by about 50% over the past decade, the entire decline has been "funded" by decreases in the amounts paid by interexchange carriers to the local exchange carriers for "access." *(John Bain, Raymond James & Assoc., 1/12/95)*

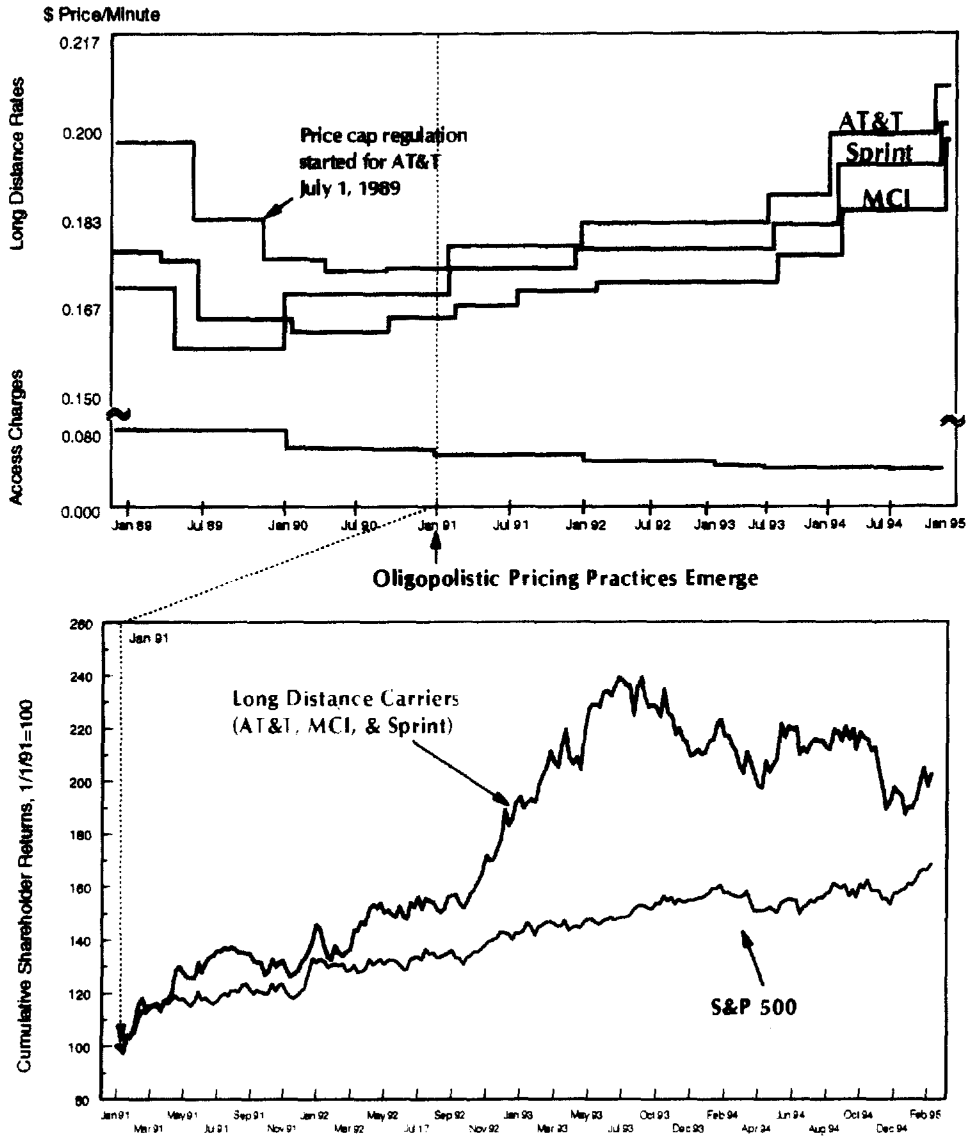
Overall, MCI's new Friends & Family program looks like just another round of discounting funded by previously announced increases in the base rates. By focusing on the discount instead of the rate, the industry has been able to quietly raise base rates while spending millions of dollars promoting ever-increasing discounts. *(D. Reingold and M. Kastan, Merrill Lynch, 1/20/95)*

Regardless of your carrier, you are paying higher and higher rates if you are among the tens of millions of Americans who have not signed up for a discount calling plan. The person paying the retail rate is bearing the disproportionate burden. And these are probably the people who can't afford to make a lot of phone calls and therefore [do not] qualify for those cheaper plans. *(D. Briere, Tele-Choice Inc., 1/21/95)*

AT&T now has the same revenues as the entire Bell system just before the break up in 1984, when they spun off about 85 percent of their assets. *(John Bain, Raymond James & Assoc., 1/24/95)*

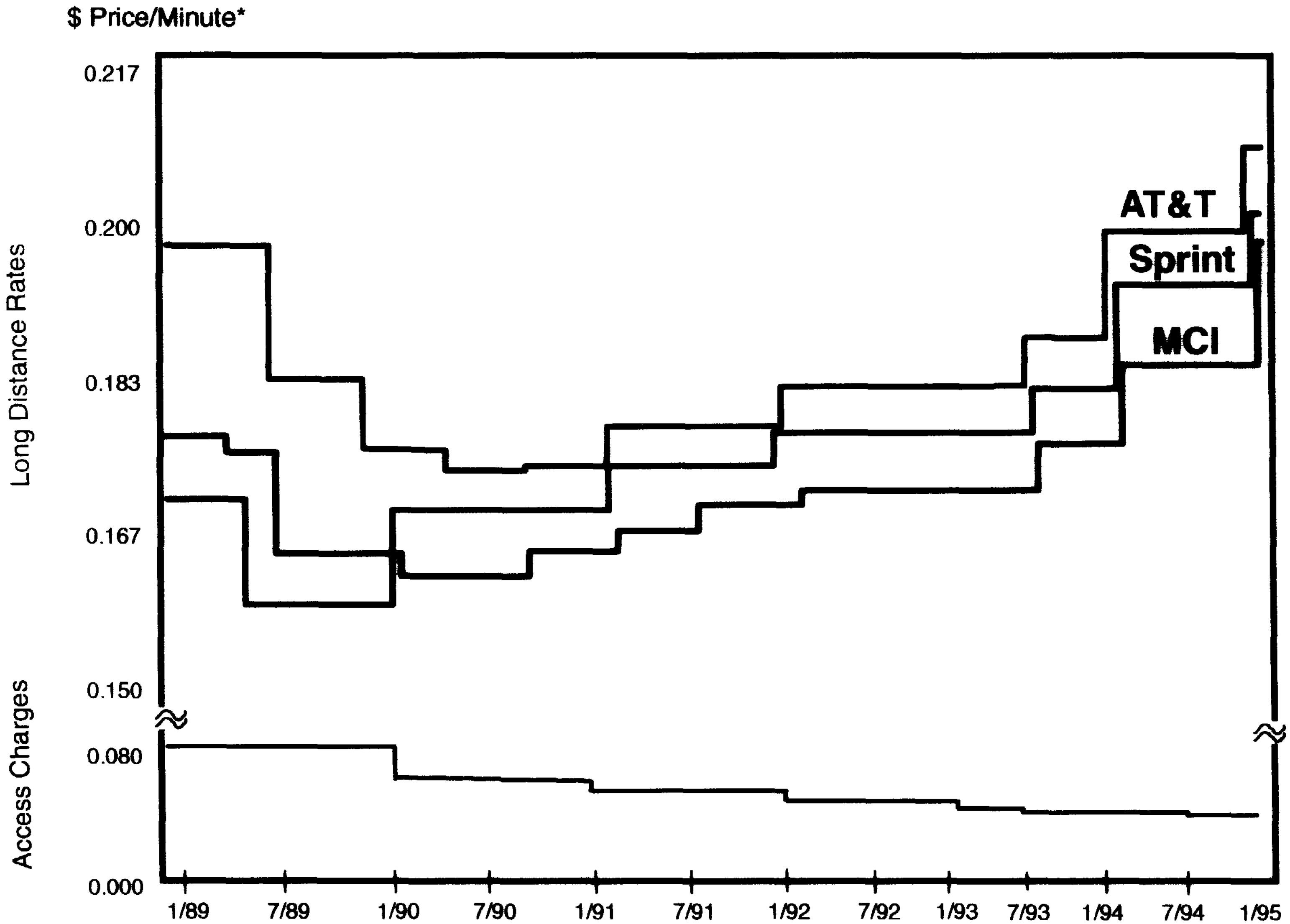
MCI. . . filed for a 3.9% across-the-board rate increase. We fully expect AT&T, Sprint, and the second tier carriers to follow suit. This move by MCI is extremely bullish for the long distance stocks since it sends a clear message to the investment community that the long distance industry will practice 'safe pricing' which will lead to stable revenue per minute trends. *(Jack B. Grubman, Salomon Brothers, 2/6/95)*

In fact, a pattern of rising [long distance] prices has emerged in the past year, with a series of AT&T price increases immediately followed by MCI and Sprint price increases. The industry must be careful not to draw the anger of the voting public as the cable industry did before suffering recently at the hands of Congress and the FCC. *(T. Weller and N. Frelinghuysen, Donaldson, Lufkin & Jenrette, 6/1/94)*



The promotions may make it look like there is price competition in residential [long distance markets], but the fact is that the base rates have created profit margins that are much better than you get from [other] businesses. *(H.B. Thompson, LCI International, 9/19/94)*

Trends in Long Distance Rates and Exchange Access Charges

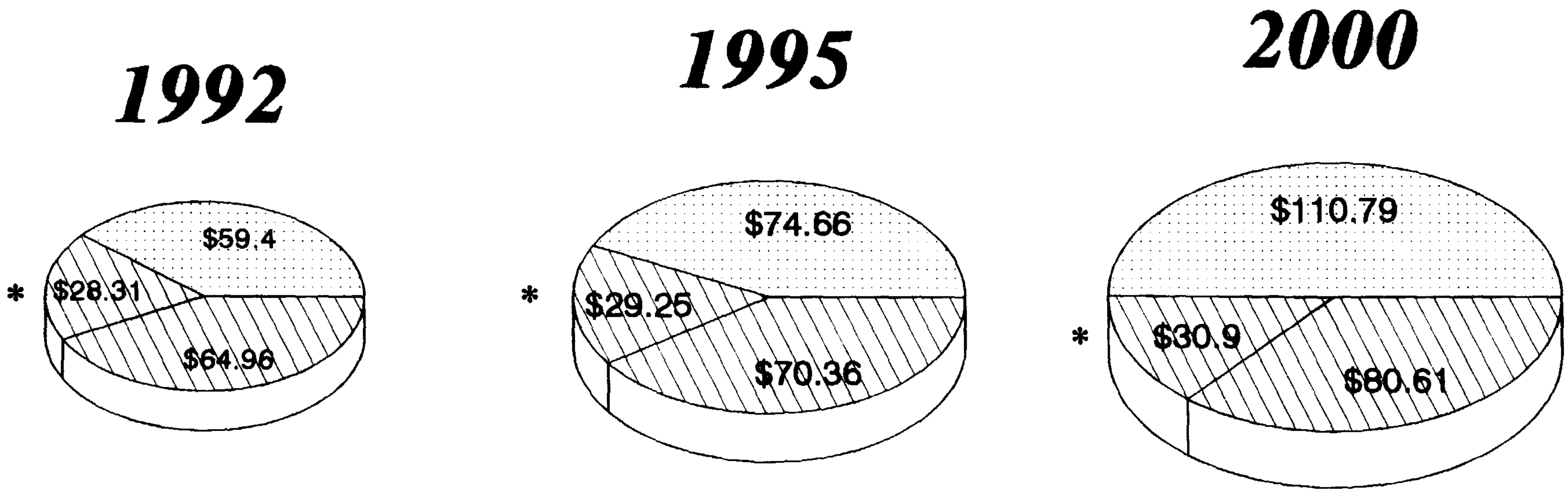


*Long distance rates based on the average price per minute for basic service.

Source: The WEFA Group

US TELECOMMUNICATIONS REVENUES

BILLIONS $



**** NETWORK ACCESS: Portion of LEC revenues received from long distance carriers.***

SOURCES: Estimated revenues based on 1991 data and growth projections from North American Telecommunications Association & Insight Research Corporation.

IXC REVENUES *LECs REVENUES*

This chart was distributed by Metropolitan Fiber Systems (MFS) at a press conference on local competition on March 7, 1995.

The Reality of Local Telephone Competition

It's a fact: local telephone service competition is already a reality.

Of the 25 most populous urban centers in America, competition for local telephone services is underway in each one. All of these cities host local access service competition; some also host local exchange service competition. Here is a list of major competitors:

Top 25 Urban Centers		Local Telephone Service Competitors
1.	New York	MFS; Teleport; MCI Metro (scheduled); Cablevision Lightpath; Time Warner (scheduled); AT&T (scheduled); NYNEX
2.	Los Angeles	MFS; Teleport; MCI Metro (scheduled); Linkatel (under construction); Pacific Lightwave (scheduled); Pacific Bell
3.	Chicago	MFS; Teleport; MCI Metro (scheduled); MCI/Jones Lightwave (trial approved); TCI (scheduled); Ameritech
4.	Washington-Baltimore	MFS; Teleport; MCI Metro; Bell Atlantic
5.	San Francisco	MFS; Teleport; IntelCom Group; Pacific Bell
6.	Philadelphia	MFS; MCI Metro (scheduled); Bell Atlantic
7.	Boston	MFS; Teleport; MCI Metro (scheduled); Time Warner; NYNEX
8.	Detroit	MFS; Teleport; MCI Metro (scheduled); Ameritech
9.	Dallas-Fort Worth	MFS; Teleport; MCI Metro; TCI; SBC
10.	Houston	MFS; Teleport; Time Warner; SBC
11.	Miami-Fort Lauderdale	MFS (under construction); Teleport; Intermedia Communications; BellSouth
12.	Atlanta	MFS; MCI Metro; Jones Intercable; BellSouth
13.	Seattle-Takoma	MFS (scheduled); Teleport; MCI Metro (scheduled); TCI; U S WEST
14.	Cleveland	MFS; Teleport (under construction); MCI Metro (scheduled); IntelCom Group; Ameritech
15.	Minneapolis-St. Paul	MFS; Fibrcom; Ameritech
16.	San Diego	MFS; Teleport; Time Warner (under construction); Linkatel (scheduled); Electric Lightwave (scheduled); Pacific Bell
17.	St. Louis	MFS; St. Louis Fibernet; Teleport; SBC
18.	Pittsburgh	MFS; Teleport; TCI; Bell Atlantic
19.	Phoenix	MFS (under construction); Teleport; Electric Lightwave; IntelCom Group; City Signal; U S WEST
20.	Tampa-St. Petersburg	MFS (under construction); Teleport; Intermedia Communications
21.	Denver	Teleport; U S WEST
22.	Portland	MFS; Teleport (scheduled); MCI Metro (scheduled); NYNEX
23.	Cincinnati	MFS (scheduled); Time Warner; Fibernet; Cincinnati Bell
24.	Milwaukee	Teleport; Ameritech
25.	Kansas City	Teleport; Time Warner; SBC

NOTE: This list is limited to wire-based competitors, most of whom have installed optical fiber. It does not include cellular, PCS or other wireless technologies that also provide access and exchange services in competition with local telephone companies.

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March 22, 1995

Via Hand Delivery

Honorable Rachelle Chong
Commissioner
Federal Communications Commission
1919 M Street, N.W.
Room 844
Washington, D.C. 20554

Dear Commissioner Chong:

This morning you asked whether, in my opinion, Congress was going to address the price cap issue. At the time of our meeting, I had not seen a copy of the Pressler draft, but now I have received a copy. It does deal with the rate of return regulations. I am attaching a copy for your consideration.

With best wishes,

Tom Railsback

Thomas F. Railsback

sr
Attachment

cc: Richard Welch (with attachment)

the preservation and advancement of universal service.

(2) CONSUMER PROTECTION.—The Commission and the States shall ensure that rates for residential telephone service remain just, reasonable, and affordable as competition develops for telephone exchange service and telephone exchange access service. Where only a single carrier provides a service in a market, the Commission or a State may establish the rate that a carrier may charge for any such service if such rate is necessary for the protection of consumers. Any such rate shall cease to be regulated whenever the Commission or a State determines that it is no longer necessary for the protection of consumers. The Commission shall establish cost allocation guidelines for facilities owned by an essential telecommunications carrier that are used for the provision of both services included in the definition of universal service and video programming sold by such carrier directly to subscribers, if such allocation is necessary for the protection of consumers.

(3) RATE-OF-RETURN REGULATION ELIMINATED.—

(A) In instituting the price flexibility required under paragraph (1) the Commission and the States shall establish alternative forms of regulation for Tier 1 telecommunications carriers that do not include regulation of the rate of return earned by such carrier as part of a plan that provides for any or all of the following—

(i) the advancement of competition in the provision of telecommunications services;

(ii) improvements in productivity;

(iii) improvements in service quality;

(iv) measures to ensure customers of non-competitive services do not bear the risks associated with the provision of competitive services;

(v) enhanced telecommunications services for educational institutions; or

(vi) any other measures Commission or a State, as appropriate, determines to be in the public interest.

(B) The Commission or a State, as appropriate, may apply such alternative forms of regulation to any other telecommunications carrier that is subject to rate of return regulation under this Act.